

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

cellular services have sold at a premium, which restricts use of such services to the high-value end of the telecommunications market. With increased PCS competition, wireless service prices have fallen, but they remain well above rates for landline local exchange service. However, prices cannot fall below costs. Moreover, current cellular/PCS architectures may be subject to decreasing returns to scale.<sup>67</sup>

65. To summarize, therefore, PCS does not currently offer effective competition for BellSouth's dominant wireline business. Moreover, while wireless technology offers one of the best hopes for effective future facilities-based competition for wireline carriers, it seems more likely that one of the new fixed-wireless technologies under development will provide the vehicle for this competition rather than wireless networks based on existing PCS architectures.

66. The analyses of Mr. Denk and Dr. Banerjee simply do not justify a contrary conclusion. Mr. Denk reports the results from a small marketing research survey conducted on current PCS users in BellSouth's territory. Based on this survey, Mr. Denk concludes that a "secondary impact of the introduction of PCS on telecommunications purchase patterns is to cannibalize some business from providers of traditional wireline service in the New Orleans, Louisiana metro area."<sup>68</sup> Because Mr. Denk provides neither a detailed description of the

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<sup>67</sup> One way to expand wireless capacity is to shrink the size of cells. However, this approach would increase the cost of siting and erecting antennas because, for example, there are less choices to site antennas and reduced opportunities to take advantage of real estate bargains.

<sup>68</sup> See *Affidavit of William C. Denk on Behalf of BellSouth*, note 10, *supra*, page 4.

survey methodology or questionnaire, nor the data to indicate how representative his sample of customer preferences, and because the questions are not quantitative<sup>69</sup>, we cannot verify whether his results are reliable. Moreover, because the sample was drawn from PCS users, it is likely to be biased and *not* representative of the average residential subscriber. Early adopters of a new technology tend to have quite different purchasing behavior than the eventual mass market (*e.g.*, they may be more prone to experiment).<sup>70</sup> Even if one were to accept his results on face value, they imply that PCS offers only limited competition in the most favorable circumstances.<sup>71</sup>

67. Dr. Banerjee provides a qualitative assessment of the types of consumers who would be most likely to switch from wireline to PCS service in the New Orleans major metropolitan area based on a comparison of current PCS and wireline tariffs. He reports that consumers with low intraLATA toll and local usage would be the most likely to switch

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<sup>69</sup> Mr. Denk's survey samples consumers' reported preferences using questions regarding their behavior in particular situations. Such self-reporting is often unreliable and difficult to interpret because of such things as framing bias and other psychological effects common to survey-based research. It is not clear how Mr. Denk controlled for these effects or if such effects were important in this case.

<sup>70</sup> We cannot easily corroborate Mr. Denk's interpretation of his results because we cannot determine whether the calls made on PCS are incremental calls or substitute calls (for example, when the PCS user reports a propensity for using the PCS phone when away from home, is that for calls that would have been made anyway on a wireline phone, or does the PCS user make more phone calls?).

<sup>71</sup> The principal "cannibalization" effect is to use the PCS as the primary phone or to purchase a PCS phone in lieu of adding a second line. Both of these are more important for higher-value consumers.

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

services. In particular, Dr. Banerjee concludes that BellSouth customers with relatively low intraLATA and local usage (*i.e.*, those with less than 40 minutes of such usage per month) would find four PCS plans (Sprint, PCS plans 1 and 2, and PrimeCo PCS plans 1 and 2) less expensive than BellSouth's wireline service. However, he reports that approximately 86 percent of customers have at least 100 minutes per month of local usage.<sup>72</sup> Nevertheless, he seems to wish to imply that his assessment that PCS is a preferred alternative for a subclass of subscribers is conservative because he fails to take into account the qualitative value of mobility.<sup>73</sup> This inference is misleading because there are many applications where PCS service is not preferable. For example, replacing a home phone with a PCS phone makes it more difficult to add extensions (*i.e.*, each PCS phone has a unique number).

68. Dr. Banerjee's analysis overlooks the fact that many consumers -- especially residential consumers -- choose their service based on their expected usage (which varies month to month) and on other features which are not part of Dr. Banerjee's analysis (*e.g.*, the reputation of the carrier or their knowledge of comparative tariff offerings). Dr. Banerjee does not explain how robust his results are to uncertainty over usage rates, nor does he

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<sup>72</sup> See *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth, supra*, note 9, page 14, Table 7. Also he does not provide sufficient detail to determine whether his service comparison is accurate. He should also include all user costs of adopting PCS services, which means including one-time non-recurring costs such as the service installation fee, the phone, etc.; how he treated these expenses, it is not clear.

<sup>73</sup> See *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth, supra*, note 9, pages 1, 23.

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

evaluate consumer comparisons between the PrimeCo and Sprint PCS plans. Based on a cursory review of the offerings in his table,<sup>74</sup> it appears that Sprint PCS rates are much higher than for Primacy, making it difficult to understand why Sprint would have any customers if we were to take Dr. Banerjee's analysis at face value. The fact that Sprint PCS and PrimeCo offer such different program options indicates that Dr. Banerjee's analysis greatly oversimplifies the nature of competitive decision-making in the market.

69. Even on its own terms, Dr. Banerjee's analysis contains three significant methodological errors. First, Dr. Banerjee's cost comparisons are based on the assumption that the customer in question would otherwise purchase *five* vertical features.<sup>75</sup> However, Dr. Banerjee's own study finds that the average BellSouth customer orders roughly two vertical features,<sup>76</sup> approximately 26.5 percent of customers order *no* vertical features, and only 13.5 percent order all five.<sup>77</sup> Indeed, it seems quite unlikely that the customers on whom Dr. Banerjee focuses -- those with fewer than 40 minutes *per month* of local usage -- would order even two vertical features. (How many customers who spend 1 minute per day on the phone order three-way calling?) This error is significant. For example, recalculation of Dr.

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<sup>74</sup> See *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth*, *supra*, note 9, page 5.

<sup>75</sup> See *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth*, *supra*, note 9, page 7.

<sup>76</sup> See *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth*, *supra*, note 9, page 14.

<sup>77</sup> See *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth*, *supra*, note 9, page 15, Table 9.

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

Banerjee's figures on the basis of the highly conservative assumption that the potential PCS customer would otherwise order an average of two vertical features from BellSouth<sup>78</sup> yields the result that Sprint's PCS plan 1 and PrimeCo PCS Plan 1 would be less expensive than BellSouth wireline service only for customers with fewer than 32 and 23 minutes of local usage a month, respectively.

70. Second, Dr. Banerjee's analysis ignores the significance of the fact that PCS users pay for both outbound and inbound calls, whereas wireline customers pay only for outbound calls. As Dr. Banerjee admits, "for each call that a typical BST *residential* customer makes, he or she is assumed to receive a call (or calls) of roughly the same duration."<sup>79</sup> For this reason, a BellSouth wireline customer who makes, say, 100 minutes of outbound local calls a month would need to compare BellSouth's rates to the cost of *200 minutes* of PCS usage. Thus, the Sprint PCS plan 1 and the PrimeCo plan 1 would, in fact, be less expensive than BellSouth's wireline service only for customers who expect less than 16 minutes and 12 minutes, respectively, of local usage *per month* or, in other words, about 30 seconds per day. Such customers are presumably quite rare.

71. Third, Dr. Banerjee compares the price of the various PCS plans with

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<sup>78</sup> Using Dr. Banerjee's data, we estimated an average price per vertical feature of \$3.56. See *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth, supra*, note 9, page 6, Table 3. We use this figure in the calculations below.

<sup>79</sup> *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth, supra*, note 9, page 4.

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

BellSouth's rates for combined local and *intraLATA toll* usage.<sup>80</sup> Yet, Dr. Banerjee's own data reveal that a majority of BellSouth's wireline customers (63.94 percent) make *no* intraLATA calls, and that 81.27 percent have less than 10 minutes a month of intraLATA toll usage.<sup>81</sup> Again, this error is significant. Two of the four plans that Dr. Banerjee considers less expensive for some BellSouth customers -- Sprint PCS plan 2 and Preimeco plan 2 -- are in fact more expensive than BellSouth's wireline service for *all* customers, regardless of the amount of local usage, once one removes intraLATA toll usage from the equation.

72. Finally, the analyses of Mr. Denk and Dr. Banerjee represent static comparisons that take existing prices as given. If PCS were an effective local service competitor to wireline services then BellSouth would be expected to respond by lowering prices; after all this is one of the expected benefits of competition. The higher the price of wireline service above cost, the more likely that PCS will be perceived as an attractive substitute for wireline service. Therefore, evidence that PCS is perceived as a substitute for wireline services at today's tariff rates may tell us more about the excessive subsidies and monopoly profits embedded in today's wireline rates than about effectiveness of PCS suppliers to restrain the market power of BellSouth.

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<sup>80</sup> *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth, supra*, note 9, page 8.

<sup>81</sup> *Affidavit of Aniruddha Banerjee, Ph.D. on Behalf of BellSouth, supra*, note 9, page 15, Table 8.

- b. **The proximity of BellSouth customers to other carriers' networks does not establish the existence of competition in local exchange markets.**

73. The proximity of potential competitors' facilities to current BellSouth revenue sources is not a proxy for actual competition. Through an "addressable revenue" analysis, BellSouth endeavors to demonstrate that there is nascent competition in Louisiana because of the relative geographic concentration of BST revenue streams and the proximity of these revenues to BST-identified competitive facilities.<sup>82</sup> Specifically, it has considered "at risk" the revenue generated by BellSouth customers who are located within 3,000 feet of selected carriers' fiber optic networks.<sup>83</sup> The analysis is misleading, because the cost, difficulty and delay in extending existing facilities to actually reach these BellSouth customers is likely to be prohibitive for many, if not most, local service competitors. Thus, the suggestion that BellSouth is in imminent danger of losing vast numbers of customers to CLECs is baseless.

74. There is thus no evidence of any local exchange competition capable of constraining BellSouth's exercise of market power in Louisiana.

**3. Introducing local exchange competition is difficult.**

75. To compete in local exchange services, an entrant must rely on the cooperation

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<sup>82</sup> *Affidavit of Gary M. Wright (Proprietary Version) on Behalf of BellSouth, supra*, note 64, ¶¶ 67-74.

<sup>83</sup> *Ibid.*, ¶ 74.

of the monopolist BOC -- in this case, BellSouth. At the very least, an entrant will need to interconnect to the BOC's facilities in order to exchange traffic between callers on the entrant's network and the BOC's. Moreover, as recognized by the Act, it is neither feasible nor efficient for an entrant to replicate all of the facilities of the BOC in order to provide service. Therefore the BOC is required by the Act to offer for sale both UNEs and wholesale versions of its retail services. For entry to be feasible, an entrant needs to be able to lease essential monopoly inputs on a flexible basis from the BOC. If these inputs are priced at efficient levels, then the entrant will be able to make the correct "make versus buy" decisions and will invest in facilities only when such investment is efficient.

76. Obviously, an entrant that is willing to focus narrowly on special access or private line services is less dependent on the cooperation of the BOC, and hence less vulnerable to anticompetitive behavior. Broad entry into local exchange services of the sort anticipated by AT&T requires entry into switched services and thereby depends on the full cooperation of the BOC. A BOC is unlikely to cooperate willingly because competition threatens its dominant market position.<sup>84</sup> It would prefer to maintain its monopoly over local

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<sup>84</sup> In noting the incentive and ability of BOCs to delay competition by refusing to cooperate, Professor Marius Schwartz noted that:

"BOCs repeatedly and successfully delayed the introduction of dialing parity, long after it was determined to be in the public interest. In Minnesota, the delay caused by repeated legal and administrative challenges was close to a decade."

*See Supplemental Affidavit of Marius Schwartz on Behalf of the U.S. Department of Justice, in the*



**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

services and be granted opportunities to expand into other services without having to face any regulatory constraints. This preference is simply consistent with profit-maximizing behavior. The Act and the FCC's Order clearly recognized the necessity of a legal mandate if a BOC such as BellSouth is to cooperate with entrants.<sup>85</sup> Indeed, if such legal mandates were unnecessary, the Act would have been unnecessary.

77. There are many price and nonprice strategies which a BOC can utilize to directly or indirectly hinder the emergence of effective competition. The price strategies are only the most obvious: If the prices charged for essential inputs are above efficient levels, then entry will be deterred. The BOC has an incentive to misrepresent cost data and to misallocate costs in order to induce regulators to set prices for UNEs, interconnection and wholesale services which are too high. The BOC has an incentive to seek to restrict the range of services and UNEs which entrants may purchase and to argue for inefficient surcharges (*e.g.*, to subsidize its carrier-of-last-resort obligations or to recover historical costs) in order to force

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Matter of Application of BellSouth Corporation to Provide In-Region, InterLATA Long Distance Services in South Carolina, CC Docket No. 97-208, Before the Federal Communications Commission, November 1997, page 15.

<sup>85</sup> The FCC's Order notes that "[a]n incumbent LEC ... has the ability to act on its incentive to discourage entry and robust competition by not interconnecting its network with the new entrant's network or by insisting on supracompetitive prices or other unreasonable conditions" (see paragraph 10 of the *First Report and Order*, In the Matter of Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Released August 8, 1996, hereafter referred to as *First Report and Order*). Moreover, the FCC recognized that the BOCs possess superior bargaining power and that a new entrant "comes to the table with little or nothing the incumbent LEC needs or wants" (see *First Report and Order*, Paragraph 15).

prices above efficient levels.

78. In addition to anticompetitive pricing strategies, the BOCs can avail themselves of a wide range of nonprice strategies which are often more difficult to detect and deter. Entry into local exchange services is difficult because it requires a huge investment and depends on cooperation from a hostile competitor. While the Act provides the public policy framework for addressing these issues (in the Section 251 requirements), implementation of these rules will be difficult.

79. Economists have identified several price and nonprice strategies which may be employed by a monopolist such as a BOC to exploit, extend, and protect its market power. First, a monopolist can exploit its market power by setting high prices, generally well above costs. Moreover, a monopolist chooses the range of products to offer based on what maximizes profits for the monopolist, not what consumers most want. In some cases, this results in poor quality (because consumers have no choice but to accept what the monopolist offers) or in other cases, excessive investments in features which appeal to only a subset of customers but for which the monopolist can force all customers to pay (*e.g.*, investments in broadband services). Traditionally, regulators have attempted to control these activities by setting quality standards, by determining what capital investments are allowed into rate base, and by setting prices for retail services -- and by restricting the monopolist's participation in competitive markets (*e.g.*, long distance services) to protect those markets and to limit the monopolist's ability to circumvent regulatory controls. However, such control is imperfect

because the monopolist BOC possesses superior information regarding the actual nature of its costs and consumer demand.

80. Second, a monopolist may seek to extend its market power by "monopoly leveraging." That is, a monopolist in one market may seek to extend its power to another related market, which is most easily accomplished when the monopolist controls an essential input in the second market. By tying or bundling the purchase of the goods in the two markets, the monopolist can extend its power over both markets. For this reason, the courts have often acted as if there is a *per se* restriction against tying where the firm has market power, in spite of the fact that more recent economic theory suggests that there can be efficiency-based motivations for tying and that the circumstances under which this is the preferred mechanism for extending monopoly power are limited. However, tying is likely to be attractive as a mechanism for avoiding rate regulation (*e.g.*, if the essential input is subject to a price ceiling that limits the BOC's ability to extract profits from its sale).

81. Third, and perhaps most likely, a monopolist is likely to seek to protect its market position by "raising its rivals' costs," a generic expression for a whole class of price and non-price predation and foreclosure strategies.<sup>86</sup> The BOC can potentially raise an

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<sup>86</sup> An upstream monopolist (*i.e.*, the BOC which controls local exchange access) generally will have an incentive to discriminate against downstream rivals (*i.e.*, interLATA competitors) as explained in recent papers by Nicholas Economides (see Nicholas Economides, "The Incentive for Non-Price Discrimination by an Input Monopolist," Mimeograph, Stern School of Business, New York University, January 1997) and by Randolph Beard, David Kaserman and John Mayo (see Randolph Beard, David Kaserman and John Mayo, "Regulation, Vertical Integration and

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

entrant's costs by manipulating any of the price or non-price terms associated with the essential inputs which the entrant requires to effectively compete in the market (e.g., interconnection services, UNEs or wholesale versions of retail services). In addition, BellSouth can provide inferior-quality service unless regulators are vigilant and contracts regarding interconnection, UNEs, and wholesale services are suitably specific in their requirements.<sup>87</sup>

82. Alternatively, a BOC may seek to create "customer switching costs" in order to make it more difficult for an entrant to attract new customers -- for example, anything which damages the reputation of the new entrant (e.g., poor-quality service due to slow delivery, maintenance or repair, or noisy local loop facilities), makes it difficult for a customer to learn

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Sabotage," Mimeograph, University of Tennessee, January 1997). The findings of these stand in contrast to the result proposed in a recent working paper by David Sibley and Dennis Weisman (see David Sibley and Dennis Weisman, "Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic and Policy Analysis," *Journal of Policy Analysis and Management*, vol. 17 (1997). Sibley and Weisman err by assuming that the downstream (interLATA) subsidiary of the BOC maximizes its own profits and fails to take account of the consequences of its decisions for the profits of the integrated company. Such an assumption is inconsistent with rational value maximization.

<sup>87</sup> For example, Ameritech attempted to frustrate the Michigan Public Service Commission's June 26, 1996 order to implement intraLATA toll dialing parity within thirty days. The BOC was required to grant a 55 percent discount on access charges in central offices where it failed to provide such parity. Ameritech actually chose to reduce access charges by 55 percent rather than to expand dialing parity beyond the 10 percent of access lines for which it had already implemented dialing parity. (See Ameritech News Release, "Ameritech to Cut Access Rates to Long Distance Companies," July 26, 1996; and *Ameritech Michigan v. Michigan Public Services Commission, MCI Telecommunications Corporation, and AT&T Telecommunications of Michigan, Inc.*, Court of Appeals Case No. 198706, Appellant Ameritech Michigan's Brief on the Merits at 12 ("Ameritech Complied With the Commission's June 26, 1996 Order By Implementing the 55% Access Charge Discount")(January 2, 1997).

about new entrants (*e.g.*, misleading advertising by the BOC), or makes it difficult for a customer who wishes to change suppliers to actually do so (*e.g.*, cumbersome procedures for effecting the transfer of customers to a new local service provider).

**4. Indirect strategies for frustrating competition are available.**

83. The preceding discussion highlights some of the more obvious direct strategies which may be employed to hinder progress towards effective competition.<sup>88</sup> There are also many indirect strategies which can be as effective in slowing the emergence of local exchange competition. These indirect strategies are even harder to detect and hence even more difficult to deter.

84. The emergence of local competition is likely to encourage the development of new and innovative products and services which will further complicate what is already a very complex marketplace. The BOC will likely engage in a wider array of markets of varying degrees of competitiveness and subject to varying degrees of regulatory oversight. Therefore, preventing cross-subsidization and other attempts to circumvent regulations by actions taken in unregulated markets will become more difficult.

85. Moreover, the possibility, on occasion, of an "efficiency" rationale for strategies that have anticompetitive consequences provides the BOC with ample opportunities to deny plausibly that a particular strategy is being employed for anticompetitive purposes. In

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<sup>88</sup> See also the more extensive discussion in B. Douglas Bernheim and Robert D. Willig, note 24, *supra*, Chapter 4.

the face of rapid technological progress, it may be impossible to reverse the damage caused by the strategy if regulators wait until the damage becomes evident. Even if the BOC were enjoined from using the anticompetitive strategy in the future, new versions of such strategies can be used, and the BOC has the first-mover advantage of being able to decide when and how to move.

86. Four classes of examples illustrate some of the strategies. First, because an entrant requires the BOC's cooperation in order to arrange interconnection, purchase UNEs, and resell wholesale services, the BOC can devote insufficient resources to the task of sustaining this cooperation. The promotion of competition will require active cooperation by the BOC; its neglect or slow response time, therefore, can be quite effective at thwarting competition. As Professor Marius Schwartz has stressed, such anticompetitive conduct can be difficult to police, because "the great asymmetry of information between a BOC and outsiders about what constitutes unreasonable delay in implementing new systems is likely to make enforcers leery of imposing heavy penalties for perceived foot-dragging."<sup>89</sup>

87. Second, the BOC may exploit its ability to discriminate selectively. Because the BOC controls the timing, design, and scope of its facility upgrades and the services it offers, it can manipulate these activities strategically to affect rivals differentially. It will be quite difficult to prove that a BOC delayed implementation of a feature required by an entrant

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<sup>89</sup> *Supplemental Affidavit of Marius Schwartz*, ¶ 38, *supra*, note 84.

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

because it wished to harm the entrant as opposed to its technical or other inability to respond sooner. Alternatively, a BOC can choose the level of quality which it offers to all entrants in such a way as to harm particular entrants selectively. For example, the BOC may argue that it is implementing a minimal functionality, "lowest common denominator" systems interface in order to avoid discriminating against limited-capability entrants when the real motivation is to deny access to increased functionality to more threatening competitors.

88. Third, seemingly "nondiscriminatory" quality degradation can be discriminatory in the following important sense: Entrants to local exchange services must establish a reputation for quality in order to attract customers, and a reduction in overall quality that coincides with the onset of competition would increase the difficulty of acquiring such a reputation. Similarly, local service quality problems which can be assigned to the onset of competition will mislead consumers regarding the benefits of competition and may make it more difficult for state commissions to implement the requirements of the Act. Finally, a reduction in quality could damage the investments of long distance carriers in their reputations for quality service, narrowing any consumer perceptions that long distance carriers offer better service than the BOC.

89. Fourth, while the Act requires the BOC to cooperate, the Act is quite complicated and its provisions and requirements are unlikely to be fully understood by the ILEC's employees. An ILEC does not need to tell its employees to be uncooperative or to try to mislead customers about the likely impact of competition. Indeed, many of the employees

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

may decide to behave in this way on their own. The BOC's employees are likely to associate the onset of competition with increased job insecurity and the language of healthy business competition often characterizes competitors as "the enemy." Therefore, by failing to devote adequate resources to supervising or educating employees of their obligations under the Act, FCC regulations and arbitrated decisions, a BOC may be able to implement a decentralized, anticompetitive strategy or have it implemented on its behalf by its employees. This is especially difficult to protect against because it does not require centralized coordination; there does not need to be a smoking gun.

90. Whether the ILEC uses neglect, fails to supervise workers adequately, strategically chooses "nondiscriminatory" service standards so as to harm competitors, allows overall quality to degrade, mobilizes opposition to competition, or other anticompetitive strategies, the effect will be the same: *Progress toward effective competition will be slowed.*

**IV. CONSEQUENCES OF BOC ENTRY INTO LONG DISTANCE SERVICES**

91. As we noted at the outset, we do not recommend the approval of BOC applications such as BellSouth's to compete in interLATA services pursuant to Section 271 of the Act at this time. We recommend delaying BellSouth's entry until the emergence of effective local exchange competition is safely assured. As long as BellSouth possesses significant market power over essential local exchange facilities, its entry into interLATA services will harm the competitive process in both local and long distance services. We



believe that the likely consequence of premature BellSouth entry will be higher long-run prices, reduced consumer choices, and poorer-quality services for both long distance and local exchange customers. On the one hand, examination of the potential *benefits* of BellSouth's entry reveals consumers would gain little, if anything. On the other hand, examination of the potential costs of BellSouth's entry reveals that consumers are likely to face significantly higher costs of service.

**A. Benefits of BOC Entry?**

92. There are three types of benefits which proponents have argued will be realized when BOCs generally are permitted to enter long distance services:

- i. Long distance markets will become more competitive.
- ii. BOCs will be able to capture additional scale and scope economies through vertical integration.
- iii. The promise of the opportunity to enter long distance services is the "carrot" which will induce the BOCs to cooperate with entrants.

93. Each of these alleged benefits is misplaced. First, long distance markets are already effectively competitive; additional entry, therefore, will not make them meaningfully more competitive. Second, BOC vertical integration is unnecessary to capture such scale and scope economies as may exist when customers can purchase both local and long distance services from a single provider. Third, the "carrot" of long distance entry is effective only as long as the BOC has not been allowed to eat it. It will be necessary to induce the BOC to

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

continue to cooperate with local exchange competitors as long as the BOC possesses significant market power over local services. The question is, again, not *if* a BOC should be allowed to compete in long distance, but *when* the BOC should be permitted.

**1. Long distance markets will not become more competitive with BellSouth entry.**

94. In Section III, we discussed the considerable evidence that demonstrates the vigorous nature of competition in long distance services. There is already significant excess capacity among just the three largest national facilities-based carriers. Moreover, the existence of a competitive wholesale market for bulk long distance transport means that entry and exit barriers for resellers are quite low. This makes the long distance market competitive (*i.e.*, free entry precludes the earning of more than normal returns by incumbents). Therefore the addition of one or even five new competitors will not meaningfully increase the level of competition. Furthermore, the BOCs would bring no new skills or resources to the market which are not already available in abundance and competing aggressively.

95. It is conceivable that long distance prices may fall in the short term if the BOCs are permitted to enter long distance services while they continue to maintain access rates vastly in excess of cost or attempt to buy market share by pricing interLATA services below cost. Such a strategy could emerge through cross-subsidization from a BOC's local service business; by integrating into long distance the BOC may strengthen its present dominant position in local services and perhaps establish future dominance over long distance services. Under such a

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

strategy, a BOC might be willing to incur a short-term loss in providing long distance service if such a loss enables it to maintain monopoly control over local services. This opportunity would not exist if the BOCs were not allowed to compete in interLATA services until local service is effectively competitive because this incentive to pursue such a strategy disappears once the BOCs no longer have market power over local services.

96. Market conditions in long distance services indicate that current prices net of access prices cannot be significantly above long run incremental costs. Therefore a temporary price war which reduces prices below incremental costs in the short run would be anticompetitive and would be likely to harm consumers' interests in the long run (*e.g.*, because of the adverse effect on incentives to invest or the adverse effect on the competitive process).

**2. Entry by BellSouth is not required to capture scale and scope economies.**

97. It is also incorrect to argue that vertical integration is required to capture scale and scope economies. First, the sources of these alleged scale and scope economies are not clear. Much of the technical progress which has made it feasible for competition to succeed in long distance markets -- and which promises the opportunity that competition may emerge in local exchange services -- has *reduced* the impact of network-level scale and scope economies. Digitalization, standardization, and modularization have made it feasible to support complex information services across networks which span multiple management and ownership domains. The Internet is a testament to this fact. Before these technical advances, it was

**FCC DOCKET CC NO. 98-121**

**AFFIDAVIT OF R. GLENN HUBBARD AND WILLIAM H. LEHR**

much more difficult to manage distributed networks and claims of significant scale and scope economies were harder to dismiss. Today, there may still exist scale and scope economies within either the long distance or the local exchange networks, but it is not clear what network economies require integration of these two networks under control of a single end-to-end firm. Today, most analysts do not believe that end-to-end telephone services are a natural monopoly. Essential local facilities do, however, remain a *de facto* monopoly.

98. Second, to the extent the use of shared facilities might create network economies of scope between local and long distance services, the realization of any such economies could improve the efficiency of production only if carriers forego the construction of separate long distance transmission facilities. As a result of the MFJ, these separate facilities have already been constructed. Under these circumstances, shifting traffic from long distance carriers to the BOCs could only result in efficiencies from economies of scope if the IXC's investments in facilities were reversible -- which they are not -- or if the incremental costs of carrying a given within-region long distance call through existing local exchange facilities was lower than the incremental costs of carrying the same call through existing IXC facilities. There is simply no reason to believe that transmission through existing local networks is cheaper on an incremental cost basis.

99. Third, suppose that scale and scope economies exist, but that they are associated with *marketing* functions rather than with the network. There is ample evidence that many consumers will prefer one-stop shopping with the opportunity to purchase both long distance

and local services from a single service provider. By bundling a package of services, a firm can economize on billing and marketing costs and can address customer-specific concerns more flexibly, thereby improving the quality of service. The promise of such opportunities for customer choice is anticipated to be one of the most important benefits delivered by increased competition in local services. However, it is essential that the customer be able to choose among more than one end-to-end supplier, and this would not occur with premature interLATA entry. Furthermore, resellers are able to capture the benefits of any marketing-level scale and scope economies.

**3. The promise of the opportunity to enter long distance services ceases to provide incentive for BOC cooperation once entry is permitted.**

100. It is clear from BellSouth's conduct described above, that a BOC has little incentive to cooperate willingly with regulatory policies which are intended to reduce its control over local exchange services. Therefore one might be tempted to argue that the BOC must be relieved of the restriction from entering interLATA services in order to provide the BOC with an incentive to cooperate in the emergence of local competition. There are a number of problems with this argument.

101. First, as we noted earlier, the carrot of interLATA entry ceases to be effective once consumed. Threatening a BOC with the possibility that it could be forced to exit if it behaves in an anticompetitive manner might not be sufficiently effective because regulators or a court may be reluctant to force a BOC to abandon sunk entry investments and it would be

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very hard to monitor its anticompetitive behavior as the earlier (and subsequent) discussion of its strategic options makes clear.

102. Second, this argument often implicitly assumes that the Act reflected a "bargain" with the BOCs in which they agreed to give up control of local services in return for something they wanted, namely entry into interLATA services. The Act could not have been a bargain with the BOCs because they had nothing to bring to the bargaining table. BOCs do not have a property right over local markets to use as a bargaining chip. The Act reflected a shift in regulatory paradigm to a new, market-based mechanism for protecting consumer -- not BOC -- interests.

103. Finally, we do not believe it would be correct to deny the BOCs the opportunity to compete in interLATA services forever. However, delaying BOC entry until there is effective competition in local markets is neither inefficient nor unfair, but necessary for the realization of the Act's goal of full competition for all telecommunication services.

**B. Costs of BOC Entry?**

104. In general, premature BOC entry into interLATA services will incur five types of costs:

- i. increasing the likelihood of anticompetitive vertical price squeeze strategies.
- ii. increasing the likelihood of anticompetitive strategies designed to raise rivals' costs, more generally.

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- iii. increasing the likelihood of anticompetitive behavior based on cross-subsidization of interLATA markets.
- iv. decreasing the likelihood that the BOC will cooperate with local exchange entrants, as required by the Act.
- v. increasing the costs of regulatory oversight to protect consumers and the competitive process, and forestalling the development of local competition.

In each case, the competitive process in both long distance and local exchange markets will be harmed if the BOC is permitted to enter interLATA services while it retains its local monopoly.

**1. The likelihood of anticompetitive vertical price squeeze strategies increases.**

105. A virtual monopolist who also sells a complementary service (by itself or through its affiliate) can impose a *vertical price squeeze* on a competitor in the complementary product market. This happens because the monopolist controls the price of an input of its competitor in the market for the complementary service.<sup>90</sup> For example, a BOC controls the price of access to the loop by an IXC. If the BOC, or its affiliate, is allowed to provide interexchange services as well, it can continue to price access to its competitors significantly

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<sup>90</sup> BellSouth affiant D. John Roberts focuses his attention on the potential for predatory pricing by BellSouth and opines that classic predatory pricing in this setting is unlikely given the financial health of the interexchange carriers. Professor Roberts acknowledges, however, that a vertical price squeeze, while not fitting within his analysis of "predation," "is clearly damaging to competition." See *Affidavit of D. John Roberts on Behalf of BellSouth*, note 8, *supra*, page 11.

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above cost while pricing to itself at cost, and thereby squeeze the profit margin of the IXC.

The vertical price squeeze can be pushed all the way up to the point where the IXC's profit margin becomes negative.

106. Implementation of a vertical price squeeze by a BOC will allow the BOC or its affiliate to charge prices for interexchange services that are significantly (and artificially) below the prices of its rivals even though the BOC may be a less efficient provider. This is a potent and quick way for a BOC (or its affiliate) to gain market share and customer loyalty for interexchange services.<sup>91</sup>

107. Presently, the access market is monopolized. In the absence of regulatory intervention, the control of the access market by the BOC results in significant monopoly profits. The existence of high profit margins allows for the possibility of the implementation of the vertical price squeeze. As the Telecommunications Act of 1996 is implemented by the state commissions and as new facilities-based competitors enter the local exchange market, the market for access services, unbundled network elements, and local exchange services should become more competitive. Such competition will render a vertical price squeeze less effective.

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<sup>91</sup> Professor Schmalensee argues that an ILEC's ability to expand long-distance output even where it is less efficient than its rivals is not problematic because the loss in economic efficiency "would be outweighed by consumer economic welfare gains from the expansion of industry output as long distance prices are driven closer to economic costs." *Declaration of Richard L. Schmalensee*, note 6, *supra*, at page 30. The argument rests on a false premise: as demonstrated *supra*, at Section III.A and *infra*, at Section VII.A, the long distance market is already competitive and prices already approximate economic costs. Therefore, there is no countervailing benefit to an ILEC's anticompetitive price squeeze.



Thus, from the point of view of the BOC, the present is the opportune moment to impose a vertical price squeeze and gain significant market share in the IXC market.

**2. The likelihood of anticompetitive strategies designed to raise rivals' costs, more generally, increases.**

108. A BOC will also be able to exercise market power by bundling services and making it more difficult for customers who subscribe to more than one service to switch carriers. Such bundling schemes will be much more effective for a firm with near monopoly market power in one portion of the bundle, here in the provision of local service. If a firm has significant market power, its competitors will have, even in the absence of bundling by the dominant firm, a difficult time attracting customers. A BOC's position as the entrenched monopoly provider will make it difficult for other firms to convince customers to switch carriers. If the BOC sells to customers bundles of local and toll services, the willingness of customers to switch will be that much less and the BOC's operation, as a whole, will be able effectively to lock in a significant portion of its customer base.

109. We stressed earlier the importance of both price and nonprice anticompetitive strategies available to the BOC. Forward integration by the BOC into long distance services would increase the span of potential markets, services and products which could provide a basis for anticompetitive strategies. This integration would expand the range of opportunities to engage in those strategies, would make it more difficult to detect or deter such behavior, and would increase incentives and opportunities to fund such behavior. For example, entry